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The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs

prepared for

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National Council of Higher Education Loan Programs

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National Economic Consulting

NEC

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Executive Summary

Federally-backed student loans are currently issued through two delivery mechanisms: by the private sector through the Federal Family Education Loan Program (FFELP), sometimes referred to as the guaranteed student loan program; and, since 1994, by the federal government through the William D. Ford Federal Direct Loan Program (FDLP).

Proponents of the FDLP have argued the direct loan program is more cost-effective because the Federal government can borrow more cheaply than the private sector and does not have to generate a profitable return. Federal budget estimates of the cost of the loan programs are often cited as evidence supporting this claim. These comparisons, however, are flawed in ways that bias score-keeping in favor of the FDLP. This report analyzes some of these budget score-keeping issues.

At the outset, it should be noted that Federal budget scorekeepers can only estimate the cost of the student loan programs, and past budget estimates of the profitability of the FDLP have proven to be inaccurate. Although negative subsidies (i.e., net gains to the Department of Education (ED)) have been consistently forecast for the FDLP in recent years, those estimates of net gains have later been revised into net costs. These revisions appear in reestimates published by the Department and the Office of Management and Budget.

The first scoring bias examined by this report concerns interest rate assumptions. Projections of FDLP savings are crucially reliant on the projected relationship between short-term and long-term interest rates – the shape of the yield curve. Importantly, compared to historical experience, the Congressional Budget Office (CBO) and the Administration understate the steepness of the yield curve in their interest rate projections. This reduces the estimated cost of the FDLP relative to the FFELP. And this bias continues going forward: long-run interest rate projections for FY 2005 by both the CBO and the Administration continue to show a flatter yield curve than has historically been experienced.

The second bias concerns tax revenues. As mentioned above, FDLP proponents believe direct lending is cheaper because FFELP must generate profits to lenders. These same profits, however, yield revenue to the Treasury in the form of tax payments. Importantly, these tax payments are not considered as an offset to the subsidy cost of the FFELP. We estimate that FFELP lenders alone generated $651 million dollars of tax revenue last year. If all student loan volume were handled by the FDLP, on the other hand, total tax revenue from the loan programs would only have been $20 million.

The third bias is the mandated exclusion of administrative costs under the Credit Reform Act of 1990, which artificially makes the Direct Loan program appear less expensive than the FFELP, the cost of which includes most administrative costs. Any shift in loan volume to the FDLP would increase the administrative cost of the program, but this is not reflected in the scoring when comparing subsidy costs in the budget.

Each of these budgetary score-keeping considerations results in cost comparisons between the two programs that exhibit a bias that favors federal direct lending over federally guaranteed lending. Under certain economic circumstances, either program can be the more expensive of the two. Our key findings in this report are summarized below.

Summary: Sensitivity of Student Loan Costs to Interest Rates

- The CBO and the Administration project that short- and long-term interest rates will differ less – have a flatter yield curve – over the long-term than shown by historical averages because they do not try to forecast economic cycles. Flatter yield curves lead to projections of "negative subsidies" for the FDLP. Subsequent reestimates based on actual data have consistently raised the government's cost of FDLP lending.

- The Administration's cost projections underestimate the impact of interest rate variability. The 8.25 percent borrower rate cap prevents future above-average rates from offsetting current below-average rates, and projections generally miss the costs associated with consolidations at fixed rates when variable rates drop.

- Estimated FDLP costs are more sensitive to changes in the shape of the yield curve than FFELP costs because the FDLP outflows generally occur in the early years of the loan, but the offsetting collections occur later.

- Using a market-based discount rate in order to recognize interest rate risk, as recently discussed by the CBO, would increase the cost of FDLP relative to FFELP.

- To the degree that projections assume historical spreads between Treasury bills and commercial paper, the costs of the FFELP are being overestimated because changes in fundamental market conditions caused these spreads to narrow in recent years.

Summary: Displacement of the Private Sector

- The true budgetary cost of the FDLP is underestimated because current calculations ignore the loss of taxes on student loan income that would have been generated under the FFELP.

- Using our mid-point assumptions, our estimates indicate that the FFELP generated $651 million of federal tax revenues in FY 2004.

- Some services under the FDLP are performed by private parties and generate tax revenues estimated at $7 million.

- If the entire FFELP loan portfolio were transferred to the FDLP, tax collections are estimated to fall by $631 million, at FY 2004 levels.

- Federal income tax payments should be recognized in any comparison of relative program costs.

Summary: Administrative Costs

- The Federal Credit Reform Act of 1990 (CRA) requires that administrative costs be excluded from the subsidy calculations for the FDLP and FFELP; however, while all administrative costs are excluded from the FDLP cost estimates, they are mostly included in FFELP estimates because most of the costs are incurred by private lenders. This inconsistent treatment makes the FDLP program appear relatively less costly than it is.

- Origination fees collected under the FDLP program are included in the subsidy estimates even though origination costs are not. Under the FFELP, origination costs are implicitly included in the lender yield, so fees and the associated costs are included in the subsidy estimates.

- The current allocation of ED administrative costs shows the administrative costs associated with the FDLP are almost five times higher relative to outstanding loans than those for the FFELP.

- Federal administrative costs for the FFELP relative to outstanding loans have been cut in half since 1991.

This report does not attempt to fully quantify the impact of the scoring biases presented above. Also, while there are other score-keeping issues related to the student loan program, they are beyond the scope of this report.

The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs

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I. Introduction

Since 1966, the federal government has subsidized loans to students for post-secondary education in order to help assure that no American is denied a higher education for lack of income or wealth. Federally-backed student loans are currently issued through two delivery mechanisms: by the private sector through the Federal Family Education Loan Program (FFELP), sometimes referred to as the guaranteed student loan program; and, since 1994, by the federal government through the William D. Ford Federal Direct Loan Program (FDLP).

Whether provided by the private sector or directly by the government, federally-backed loans to students and parents all carry the same basic federal subsidy characteristics: federal assumption of principal losses in case of default,[1] federal payment of interest while the students are in school (for certain Stafford loans), and a federal interest subsidy for all loans during other periods (in the form of a below-market interest rate charged to the student, which is capped at 8.25 percent). So-called "unsubsidized" loan programs do not have the in-school interest payment feature; but "subsidized" Stafford loans, which constitute the largest part of the FFELP and FDLP, do have it. Nevertheless, both "subsidized" and "unsubsidized" student loans retain the federal principal guarantee and below-market interest rate (i.e., even "unsubsidized" loans are, in fact, subsidized). Also, it is important to note that for both types of loans the interest subsidy increases if borrower interest rates, as determined by a formula, would otherwise exceed the 8.25-percent cap (9 percent for parent loans).

Under FFELP, private-sector financial institutions (e.g., banks and credit unions) lend private capital to eligible students and parents at below-market interest rates (determined by statute). Public or private guaranty agencies insure the loans, and the federal government reinsures the loans against default. The federal government also provides an interest subsidy to the lender to compensate for the difference between the below-market rate received from the borrower and the (higher) competitive market rate of return on the lender's invested funds.

Under the FDLP, loans are issued to students and parents by the federal government without the involvement of private-sector lenders or guaranty agencies, though many loan originating, servicing, and collection functions are contracted out to private-sector providers. The interest rate paid by borrowers is the same under both programs.

[1] Actually, most FFELP lenders share a small part of the risk of loss if borrowers default. The federal government reimburses them for only 98 percent of defaulted principal. However, a lender or lender servicer designated for exceptional performance is eligible to receive 100 percent reimbursement on all claims submitted for insurance during their period of designation. Once a loan goes into default, the ED only reimburses guaranty agencies at most for 95 percent of the defaulted amount.

Students and parents can consolidate their FFELP or FDLP loans into a single loan under both programs. The rate on the consolidated loan will be fixed at the weighted average rate of the consolidated loans, and the rate will not vary with interest rates at or subsequent to the time of consolidation. Consolidated loans have the same federal guarantee and guaranteed yield for private lenders.

Proponents of the FDLP have argued that student lending activities should be consolidated in the public sector because the federal government can borrow more cheaply than the private sector and does not have to generate a profitable return. This argument, however, ignores certain aspects of the two programs that make the FDLP look less expensive than the FFELP. This report will analyze some of these issues. The first section discusses the sensitivity of the student lending program to interest rates. The second section examines the implications on federal tax revenues of moving FFELP lending to FDLP. The third section analyzes the administrative costs of the two programs.

II. Interest Rate Sensitivity

Summary: Sensitivity of Student Loan Costs to Interest Rates

- CBO and the Administration project that short- and long-term interest rates will differ less – have a flatter yield curve – over the long-term than shown by historical averages because they do not try to forecast economic cycles. Flatter yield curves lead to projections of "negative subsidies" for the FDLP. Subsequent reestimates based on actual data have consistently raised the government's cost of FDLP lending.
- The Administration's cost projections underestimate the impact of interest rate variability. The 8.25 percent borrower rate cap prevents future above-average rates from offsetting current below-average rates, and projections generally miss the costs associated with consolidations at fixed rates when variable rates drop.
- Estimated FDLP costs are more sensitive to changes in the shape of the yield curve than FFELP costs because the FDLP outflows generally occur in the early years of the loan, but the offsetting collections occur later.
- Using a market-based discount rate in order to recognize interest rate risk, as recently discussed by CBO, would increase the cost of FDLP relative to FFELP.
- To the degree that projections assume historical spreads between Treasury bills and commercial paper, the costs of the FFELP are being over-estimated because changes in fundamental market conditions caused these spreads to narrow in recent years.

Budget cost estimation for student loans, whether direct or guaranteed, follows the procedures laid out in the CRA. The CRA requires that when a federal agency makes a loan directly or guarantees a loan made by another party, the agency must estimate how much of that credit (over its entire life) will end up being subsidized by the federal government. Prior to the CRA, loan and guarantee program costs were accounted for on a purely cash-flow basis, with program outlays and revenues accounted for in the year in which they occurred. This created the appearance of a much lower budgetary cost of guaranteed loans relative to direct loans because of the different timing of cash flows under the two programs.

With the CRA, the Congress sought to make the costs of federal credit programs more comparable to those of other programs and to bring the full cost of loan guarantees on-budget, by defining budget costs for loans and guarantees in terms of the net present values of the federal government's cash flows over the life of the loan or guarantee. The aim of credit reform was to report the government's entire expected loss from direct and

guaranteed loans in the year the loans are made. Annual subsidy cost revisions are required based on the actual experience with each year's loans.

Interest rates are the primary determinant of the federal costs of the student loan program. Borrower rates and payments to lenders in the FFELP are tied by statute to certain market rates. First, the rate that borrowers pay on outstanding Stafford and parent (PLUS) loans depends on short-term Treasury yields under both the FDLP and FFELP.[2] Second, the guaranteed yield to private lenders under the FFELP depends on the return on short-term commercial paper. Finally, the interest that the Department of Education (ED) pays Treasury for its borrowing under the FDLP, as required by the CRA, is determined using the effective interest rate as computed by the OMB's "basket-of-zeroes" discounting method. The "basket-of-zeroes" discounting method defines the present value of a series of payments as the value today of a collection of zero-coupon bonds that, at maturity, exactly match the cash flow observations. This largely will reflect interest yields on intermediate- and long-term Treasury debt. Table 1 below summarizes the relationships between the required payments under the student loan program and market interest rates.

Table 1. Student Loan Rates Through FY 2006

	FFELP			***FDLP***		
	Stafford Guaranteed	*Consolidated*	*PLUS*	*Stafford Direct*	*Consolidated*	*PLUS*
Borrower Rate: bond-equivalent yield on 91-day Treasury bills plus:						
Deferment Period	1.7	Wtd avg of loans	3.1	1.7	Wtg avg of loans	3.1
Payment Period	2.3	Wtd avg of loans	3.1	2.3	Wtd avg of loans	3.1
Borrower Cap	8.25	8.25	9.0	8.25	8.25	9.0
Guaranteed Lender Yield: Rate on 3-month corporate paper [a] plus:						
Deferment Period	1.74	2.34	2.64 [b]	NA	NA	NA
Payment Period	2.34	2.34	2.64 [b]	NA	NA	NA
ED Payments to Treasury on Borrowing						
Deferment Period	NA	NA	NA	Wtd avg of yields on Treasury debt of similar duration, based on period of disbursement		
Payment Period	NA	NA	NA			

[a] Average yield over quarter on 3-month commercial paper of financial institutions, published by Federal Reserve.

[b] PLUS lenders receive the guaranteed yield only if the borrower rate reaches the 9.0 percent cap.

[2] For loans first disbursed after June 30, 2006, a fixed rate of 6.8 percent is scheduled to apply for most student loans; a 7.9 percent rate will apply to parent loans.

Current scorekeeping practices impose certain biases in the estimated costs of the student lending program. Given the importance of interest rate assumptions, this section will discuss the sensitivity of the estimated costs of the program to changes in interest rates.

A. Yield Curve

Under the FDLP, the ED finances the loans with Treasury borrowings and repays the funds as students repay their student loans. The ED pays interest to the Treasury on the net borrowed amounts. The ED's interest expense is primarily based on intermediate- to long-term rates on Treasury debt.[3] Because most of the student loan principal will be paid off late in the life of the loan, the effective interest rate that the ED pays to Treasury is generally consistent with long-term rates.

By contrast, the rate that borrowers pay to the ED on their direct loans is based solely on short-term Treasury debt. This rate is reset on July 1 each year based on the final auction in May.

Under certain circumstances, the payments that the ED receives from borrowers on direct loans can exceed the payments that ED must make to Treasury to service its debt. This is the result of the number of factors, including the spreads described in Table 1 (1.7 percent, 2.3 and 3.1 percent), defaults and recoveries, other costs and fees, and in significant part, the shape of the yield curve. In such a case, the ED can make arbitrage gains on the student loan. In certain interest rate environments, these gains can be large enough to offset those costs included in the CRA formula, thus generating a "negative subsidy," or a net gain to the ED. In general, negative subsidies will only arise when short-run rates (which determine the amounts borrowers pay on loans) are relatively close to or higher than long-run rates (which determine how much the ED pays Treasury). In other words, the yield curve on Treasury debt must be relatively flat or negatively-sloped to result in a negative subsidy.[4]

Published interest rate projections made by the Administration and the CBO are limited to three-month and 10-year Treasury rates. These rates can be used to indicate the projected shape of the yield curve and to make comparisons with historical experience.

The difference between 10-year and three-month rates has been highly variable and the more the 10-year rate exceeds the three-month rate, the steeper the yield curve. In

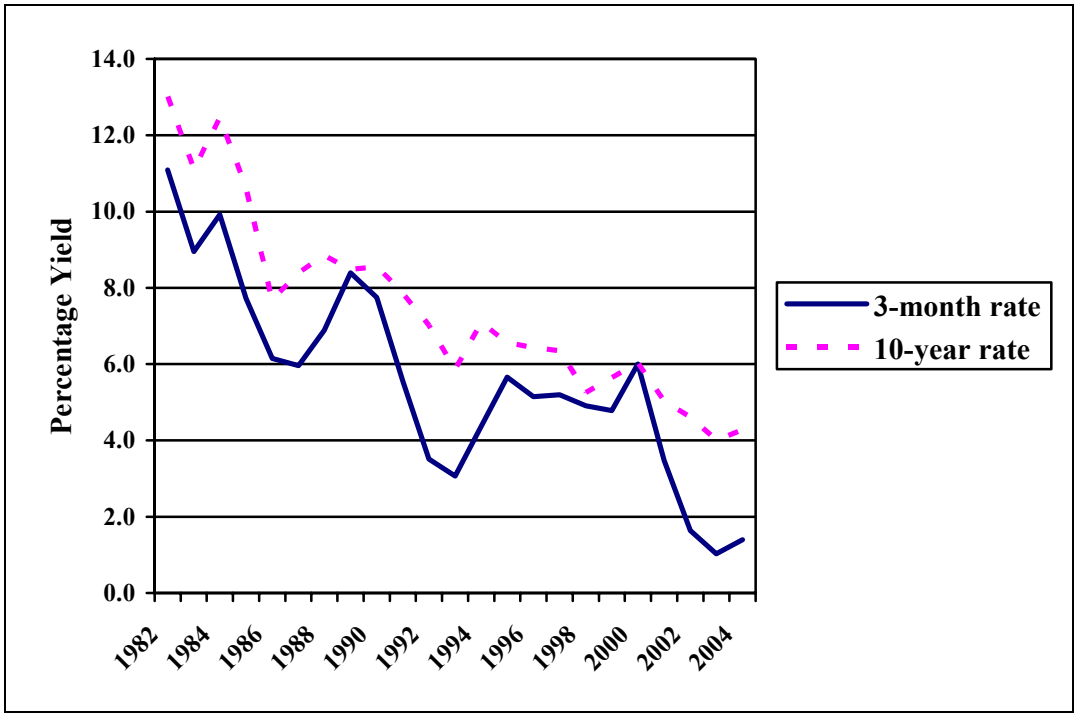
[3] Consistent with the CRA, the ED takes a yield curve based on Treasury debt of varying terms with the coupon payment stripped off (often referred to as a "basket-of-zeroes"), and calculates a weighted average yield based on the timing of the disbursements and the terms of the underlying student loans. A "basket-of-zeroes" refers to a basket of zero-coupon Treasury notes and Treasury bills with different maturities. The interest rates, or yields, on the debt can be used to discount the value of future amounts to the present. By combining the yields on Treasury debt with different maturities, a yield curve can be constructed.

[4] Because of the 1.7, 2.3, or 3.1 percent incremental costs for borrowers on top of the short-term Treasury rate (see Table 1), the yield curve can be moderately positive and still result in a negative subsidy. This same effect can occur if there is a significant upward shift in the entire yield curve after the program year; i.e., long-term and short-term rates rise by the same amount in years after the loans were issued. In this case, the short-term rate can be higher than the long-term rate originally used to establish the ED's interest cost, while remaining below the long-term rate in that subsequent period. While long-term interest rates do change over time, they tend to vary less than short-term rates.

general, the slope of the yield curve varies based on expectations with regard to the economic cycle and inflation. The yield curve often steepens when the economy slows and inflation is less of a concern as the Federal Reserve pushes down short-term rates to encourage recovery. Conversely, the yield curve tends to flatten as short-term rates rise during a recovery.

Figure 1 below compares the average rates on three-month Treasury bills and 10-year Treasury notes between 1982 and 2004. During that period, the average spread between the two rates is 1.85 percentage points (or 185 basis points).

Figure 1. Yields on Three-Month Treasury Bills and 10-Year Treasury Notes, 1982-2004



Source: Federal Reserve (http://www.federalreserve.gov/releases/h15/data.htm), Department of Treasury data.

In the FY 2006 budget projections, both the CBO and the Administration estimate that the long-term spread (i.e., after the initial forecast period) between three-month and 10-year Treasury debt will be much smaller (at 90 basis points and 150 basis points, respectively).

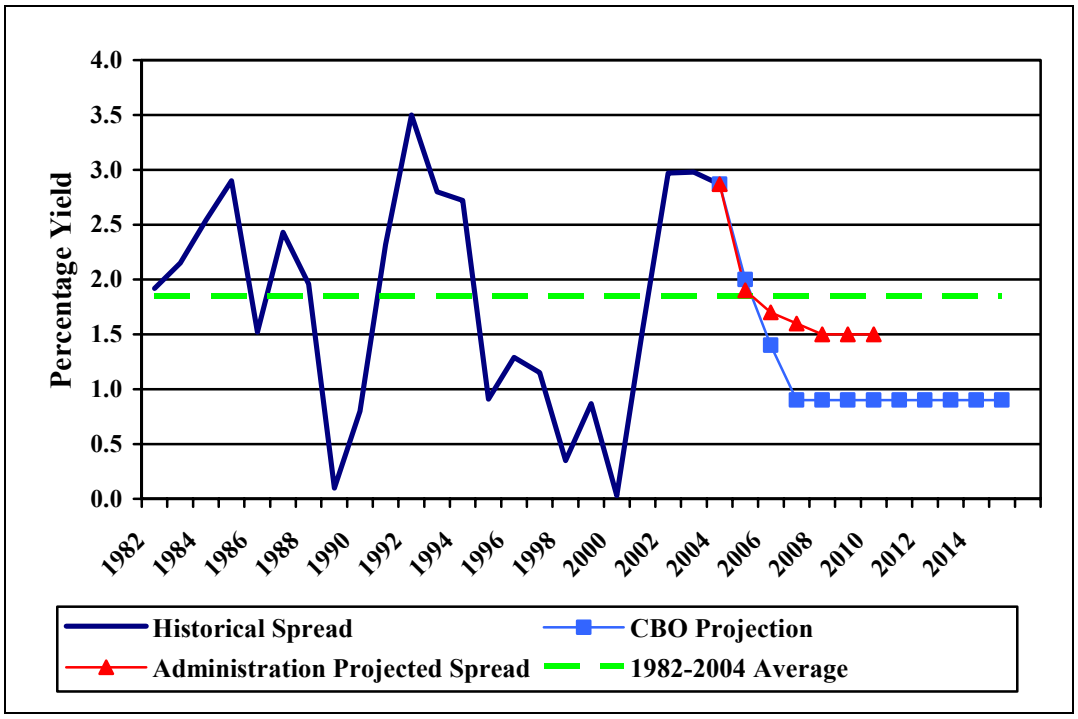
As discussed in Appendix E of "The Budget and Economic Outlook: Fiscal Years 2006 to 2015," the CBO does not attempt to make accurate year-by-year projections beyond 24 months.

> *The Congressional Budget Office did not try to explicitly incorporate cyclical fluctuations into its projections for years after 2006. Instead, the projected values shown in the tables for 2007 through 2015 reflect CBO's assessment of average values for that period--which take into account the potential ups and downs of the business cycle.*

The relative flatness of the yield curve incorporated in the CBO's projections will have the effect of increasing the apparent disparity between the CBO's cost estimates for the FDLP and FFELP, which in turn may bias congressional consideration of the two programs. Administration estimates will lead to a similar, although somewhat less pronounced, result. Incorporating economic cycles would increase the slope of the projected yield curve, which would increase the projected costs of the FDLP program. For instance, assuming that short term rates were 35 basis points lower because of economic cycles would decrease collections under the FDLP by $300 million each year, given that there were $85 billion in outstanding student loans under the FDLP in 2003.[5] This figure would reach $807 million each year assuming that short-term rates were 95 basis points lower (the difference between the 1982-2004 average spread and the CBO projected spread).

[5] Note that changing the slope of the yield curve would have a different overall impact on the FFELP. Special allowance payments depend on the difference between the yields on short-term commercial paper and short-term Treasury bills, so a change in the shape of the yield curve could have no impact on SAPs (if the two short-term rates both move by the same amount). If the spread between them narrows, SAPs will fall.

Figure 2. Excess of 10-Year over Three-Month Treasury Yields: Actuals (1982 – 2004) and Projections (2005 – 2015)



Source: Federal Reserve; CBO *Economic and Budget Outlook, 2006-2015*, January 2005; Administration FY 2006 Budget.

The budgetary costs of the FDLP depend on the assumed slope of the yield curve. The CBO and the Administration have good reason not to attempt to forecast economic cycles over the long term, but the absence of these cycles and the relative flatness of the yield curve result in the costs of the FDLP being artificially low.

B. Variability of Rates

The costs to the FDLP are driven by interest rates, which can exhibit significant variation. In general, it would be reasonable to assume that periods with unexpectedly low interest rates will be offset by other periods with higher-than-expected interest rates, so using average interest rates to estimate the costs of the FDLP would produce accurate results. However, certain aspects of the cost estimates of the FDLP prevent this "true-up" from occurring and result in FDLP losses that may never be regained.

In periods of low interest rates, the FDLP will generally accumulate losses on outstanding loans. As discussed above, the ED funds FDLP loans by borrowing from Treasury and assigns a fixed cost of funds to those amounts based on the yield curve when the money is borrowed. Therefore, if short term interest rates fall during the life of a loan, the ED's cost of funds for that loan does not change but payments from borrowers, which vary based on short-term rates, will fall, resulting in losses on outstanding loans.

These losses could be offset by future periods of high interest rates, but only if borrower rates were free to move with short term interest rates. However, the 8.25 percent cap on borrower interest rates prevents the ED from recouping past losses by collecting above-average interest amounts when interest rates are high. Indeed, if borrowers perceive interest rates as being likely to remain high for an extended period, they may seek to pay off the loan more quickly, which will reduce the period of time in which the ED can make up the shortfall.

Additionally, loan consolidations allow borrowers to convert the variable rates into fixed rates.[6] Consolidation activity has increased significantly during the past several years as borrowers have taken advantage of the current low interest rate environment to lock in low rates on their student loans. By consolidating at a relatively low rate, the borrower will eliminate the possibility of facing higher variable rates in the future and may seek to extend the term of the loan for as long as possible so as to derive the greatest benefit.

As a result, losses incurred in periods of low interest rates may never be fully offset by gains in periods of high interest rates.

C. Revisions to Past Estimates

Because FDLP budget costs are recorded on a present value basis when loans committed are disbursed, subsequent year changes to originally projected loan cohort costs are included as current-year "reestimates." For instance, the FY 2006 budget contains an "actual" amount for the FDLP in 2004, but it remains an estimate of the present value of loans disbursed in FY 2004. The estimate includes actual collections and disbursements made in 2004, but many 2004 loan cohort costs have yet to occur; the "actual" budget figure is uncertain and will remain subject to potentially significant revisions until the cohort is fully paid. As more 2004 loan cohort experience is accumulated, its projected cash flows are updated and the present value subsidy cost is reestimated. Corresponding reestimates are prepared for all other outstanding loan cohorts, and a reestimate plug is recorded as a current-year budgetary adjustment to capture the changes to prior years' estimates.

In the FY 2006 budget, the Administration presents the original estimates and the current estimates of all FDLP loans disbursed between fiscal years 1994 to 2004.[7] The combined total of the original estimates for the 1994-2004 loans was a negative subsidy of $2 billion. Under current projections, however, the costs were reestimated to be $5 billion higher, for a total subsidy cost of $3 billion.

The Government Accountability Office (GAO) provided a breakdown of the reestimates by year for loans disbursed between 1995 and 2003. As presented in Table 2, the GAO found that overall the revisions to the original estimates almost exclusively increased the expected costs of the FDLP. In the two years with negative revisions, 1995 still

[6] The President's FY 2006 budget has proposed the elimination of fixed rates on consolidated loans.

[7] The first FDLP loans were provided in Program Year 2005, which began July 1, 1994, so some loans were given out in FY 2004.

represents a net loss (just not as large as originally estimated), and 2003 loans are still relatively new and could be significantly revised in the future.[8] Cumulatively since 1995, the FDLP has failed to generate the budgetary savings -- the original justification for the program.

Table 2. Revisions to Estimated Cost of FDLP
(Fiscal years, Dollars in millions)

	Cohort									
	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*Total*
Original estimated loss (gain)	490	237	336	213	(378)	(1,316)	(852)	(781)	(292)	(2,343)
Reestimates:										
1996	(6)									(6)
1997	(157)	128								(29)
1998	(58)	153	80							175
1999	(81)	(71)	(69)	(129)						(350)
2000	(69)	(382)	(444)	(861)	(668)					(2,424)
2001	(87)	(190)	(229)	(160)	94	1,065				493
2003	162	397	607	1,026	792	1,079	237	270		4,570
2004	164	250	300	425	425	282	832	(70)	(33)	2,575
Total	(132)	285	245	301	643	2,426	1,069	200	(33)	5,004
Current reestimated loss (gain)	358	522	581	514	265	1,110	217	(581)	(325)	2,661

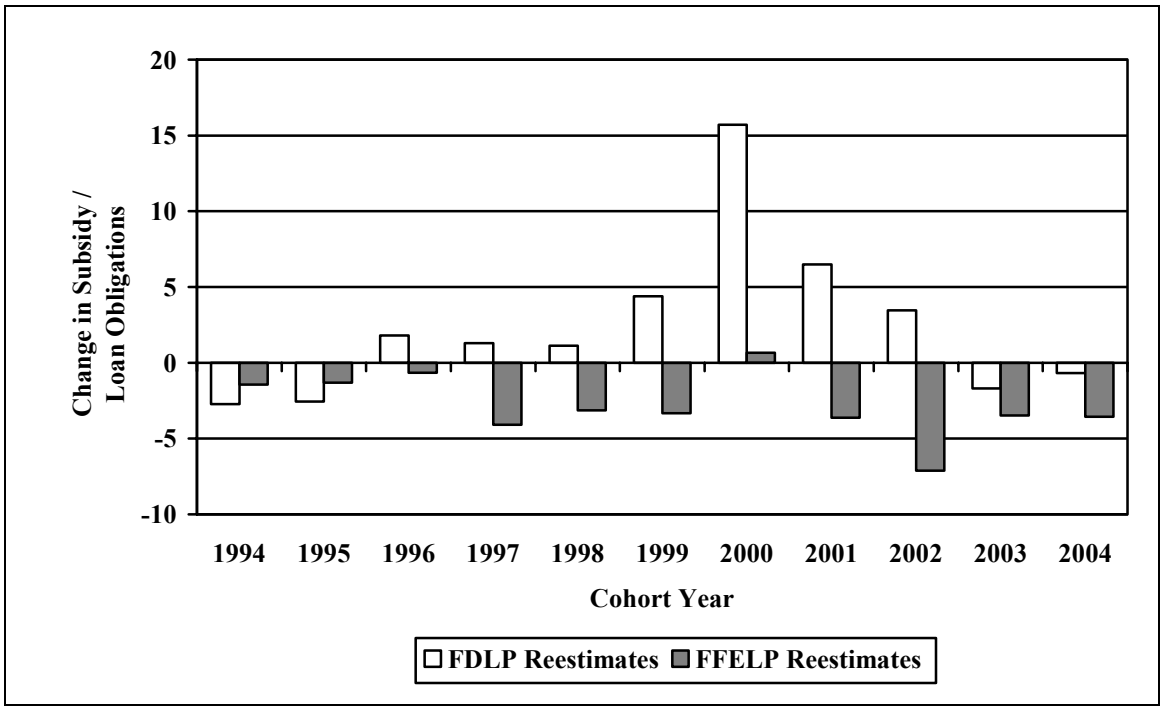
Note: OMB did not execute the reestimates in 2002.
Source: GAO Analysis of data from the Department of Education, in GAO, *Department of Education's Federal Direct Loan Program*, GAO-04-567R, March 29, 2004.

At least a portion of these reestimates are attributable the yield curve assumptions, as described in the previous section. Indeed, a large portion of the reestimates appears to be attributable to shortfalls in interest collections. On a cash flow basis, interest receipts were $6 billion (67 percent) lower than expected in the fiscal year period from 1995 to 2005.[9] Some of this shortfall is related to unexpected consolidation activity (principal receipts were $2.7 billion higher than expected in that period), and this difference also is the result of inaccurate interest rate projections as borrowers are much more likely to consolidate loans in a low interest rate environment.

[8] Given assumptions on the yield curve discussed above, it will not be surprising if the eventual costs of the 2003 loans are higher than originally estimated.
[9] See GAO, *Department of Education's Federal Direct Lending Program*, March 29, 2004.

Reestimates to the FFELP have consistently moved in the opposite direction: in every fiscal year since 1994 (except for 1998), projected FFELP subsidy costs have been larger than reestimated costs. The FY 2006 budget reports that between the 1992 to 2004 period, net reestimates lowered the cost of the FFELP by $7 billion. Figure 3 below illustrates the subsidy rate reestimates for the FFELP and FDLP. Reestimates have consistently increased the subsidy costs of the FDLP and lowered the subsidy costs of the FFELP, bringing the costs of the programs closer together.

Figure 3. Change in Subsidy Rate Estimates by Loan Cohort, 1994 –2004
(Current Subsidy Estimate – Original Subsidy Estimate)



Source: FY 2006 Budget, Credit Subsidy Supplement, Tables 7 and 8.

Although FDLP cost projections have been increased to reflect actual experience, projections still rely on future relationships that underestimate the costs of the program (such as the relatively flat yield curve discussed above). Incorporating assumptions about future interest rates that are more consistent with historical experience would increase the estimated FDLP loan costs in recent years, most likely erasing the negative subsidies currently projected.

D. Example Calculation: FY 1999 Direct Loans

The sensitivity of estimated FDLP costs to changes in the interest rate can be illustrated through use of a loan cohort that has been disbursed and now is in repayment. For instance, the original estimated cost of funds from the Treasury for loans disbursed in FY 1999 was assumed in the FY 1999 budget to be 6.03 percent, based on the yield curve

and projections of the underlying repayment of principal by borrowers. During the period 1999 through 2005, the estimated borrower interest rate gradually increased from 6.6 percent to 7.0 percent. The spread between these rates resulted in a projected net gain to the ED, starting at 0.57 percent and rising to 0.97 percent.

As shown in Table 3, based on the ED's actual experience since the budget was published, the estimated net gain was larger initially – 1.19, 0.65, and 2.52 percent in 1999, 2000, and 2001, respectively, rather than the original estimates of 0.57, 0.47, and 0.97 percent. However, borrowers receiving subsidized loans did not have to pay interest while in school, which would erase any interest collections in the first several years. The difference between the borrower rate of interest and the ED's cost of funds turned into a net loss from FY 2003 through FY 2005. Thus the 0.97 percent savings originally projected for 2005 became a 2.30 percent cost. Given the typical maturities of student loans, the FDLP still is a relatively recent program and the actual net saving or net costs of a mature program remain unknown.

Table 3. Estimated and Actual Interest Rates for Direct Loans Disbursed in FY 1999

	1999 [a]	*2000* [a]	*2001*	*2002*	*2003*	*2004*	*2005*
Estimated Rates							
Borrower Interest [b]	6.60	6.50	7.00	7.00	7.00	7.00	7.00
Cost of Funds [c]	6.03	6.03	6.03	6.03	6.03	6.03	6.03
Net Gain	0.57	0.47	0.97	0.97	0.97	0.97	0.97
Actual Rates							
Borrower Interest [b]	6.86	6.32	8.19	5.99	4.06	3.42	3.37
Cost of Funds [c]	5.67	5.67	5.67	5.67	5.67	5.67	5.67
Net Gain	1.19	0.65	2.52	0.32	-1.61	-2.25	-2.30

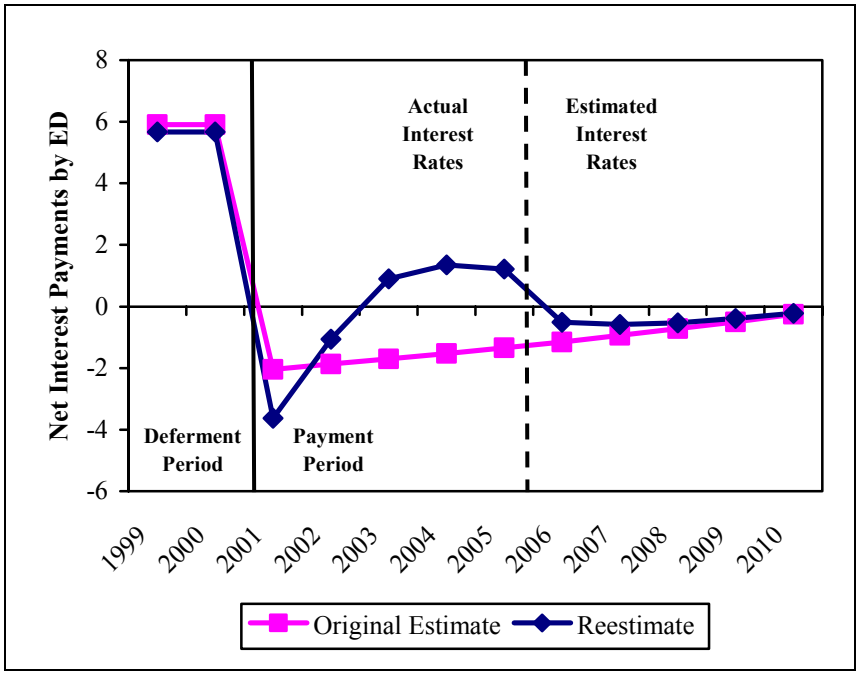
Source: FY 1999 and FY 2001 Budgets, PricewaterhouseCoopers calculations.
[a] Student assumed to be in school in 1999 and 2000, so the borrower interest rate is the yield on the 91-day Treasury bill plus 1.7 percentage points. Once the student is out of school (2001 and later here), the add-factor is 2.3 percentage points.
[b] For subsidized loans, borrowers do not pay interest while in school so the actual cash flow to the ED in the first several years was zero.
[c] For the sake of simplicity, the ED calculates interest paid to Treasury using a single rate of interest that is consistent with the yield curve and the underlying repayment of principal by borrowers.

Figure 4 below illustrates the general time pattern of the estimated net interest costs for a representative loan of $100 disbursed in 1999. During the in-school deferment period (1999 and 2000 in the figure below), the ED must pay interest on the funds it has borrowed from Treasury but receives no payments from students. Once students entered

the repayment phase, the interest payments were projected to more than offset the ED's payments to Treasury. From 1999 to 2010 (the loan is assumed to be paid off in 2010), net interest payments by the ED on the $100 loan are estimated to be -$0.20 (i.e., the ED interest payments to Treasury are more than offset by interest payments from borrowers).

Based on actual interest rates through 2004 and Administration projections through 2010, the pattern of debt service payments associated with the representative $100 loan disbursed in 1999 looks quite different. As shown in Figure 3, the net interest costs to the ED start out approximately the same as estimated but were higher than estimated once repayment began. From 1999 to 2010, the net interest payments are now estimated to be $7.89 (i.e., the ED pays out almost $8 more in interest than it receives from borrowers).

Figure 4. Illustrative 1999 Net Interest Payments Associated with $100 Direct Loan



Source: PricewaterhouseCoopers calculations.

Figure 4 simplifies the FDLP costs recorded in the budget by omitting certain inflows and outflows. Defaults would increase outflows (offsetting the borrower payments), and fees paid by borrowers would increase cash inflows in the early years. Including these flows would affect the outcome if reestimated flows for defaults and fees were significantly different than the original estimates (for instance, if defaults were originally underestimated, they would result in higher net costs).

The 1999 cohort is not a unique example where the ED was simply "unlucky" with its interest rate assumptions; other years exhibit a similar pattern. Indeed, while negative

subsidies have been forecast consistently for the FDLP, almost all loan cohorts are now expected to produce net losses.

E. Discount Rate

Interest rate projections change periodically with the federal budget cycle and lead to changes in the discount rates used in estimating FDLP and FFELP subsidy costs. These discount rate changes have asymmetric impacts on the estimated subsidy costs of the two programs due to differences in the timing of their cash flows. First, changes in the slope of the yield curve affect the present values of cash flows under the two programs differently. By way of illustration, we focus on the largest components of FDLP and FFELP outlays and revenues for "subsidized" Stafford loans and ignore administrative costs, default costs and fees.

Direct loans are characterized by an initial outlay of loan principal, followed by a few years during which the student is in school, deferment, or the grace period when no interest or principal repayments are received (but financing costs are incurred), and then followed by a longer period of interest and principal repayments. Guaranteed loans are characterized by in-school interest and special allowance payments (SAPs) to lenders during the course of the in-school and deferment period, followed by only SAPs for the remainder of the loan term.

With these cash-flow patterns (and other factors held constant) an increase in the slope of the yield curve (the relationship of short-term to long-term interest rates) causes direct loan subsidy costs (in net present value terms) to rise relative to guaranteed loan costs, because FDLP revenues from interest and principal repayments are relatively weighted toward the intermediate- to long-term, and under the basket-of-zeros methodology an increase in long-term rates results in these revenues being discounted more heavily. Conversely, a flattening of the yield curve decreases the estimated subsidy cost of direct loans relative to guaranteed loans. Thus, direct loan costs are much more sensitive than guaranteed loan costs to changes in the slope of the yield curve. As a result, the difference in costs between the two programs can swing widely from year to year.

In general, FDLP subsidy costs will increase and FFELP costs will decrease as the discount rate rises. FDLP future cash inflows will be worth less (i.e., government costs will increase) because they will be discounted at a higher rate. Similarly, the guarantee payments and SAPs paid to FFELP lenders will be discounted at a higher rate, lowering their present valued cost to the government.

The CBO recently discussed using discount rates for federal credit programs that more closely align with market-based rates.[10] In general, the risks associated with a loan should not depend on whether the loan came from a government program (FDLP or FFELP) or a private source. However, using the government's risk-free rate of return to

[10] See Statement of Douglas Holz-Eakin, *The Economic Costs of Long Term Federal Obligations*, testimony before the Senate Budget Committee, February 16, 2005, and CBO, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, August 2004.

discount the cash flows associated with a loan suggests that the program, from the economy's point of view, carries a lower risk.

If student loans were made in the absence of the government guarantees, lenders would have to address the risk associated with the loans, whether by hedging with other financial instruments or by setting aside more risk-based capital, as would be required by financial institution regulators. The government faces the same amount of risk, and the CBO argues that the discount rate should reflect the true measurement of the risk associated with the loan, as measured by the market. Therefore, a market-based rate should be used to discount the cash flows associated with direct loans and loan guarantees made by the government. Because market-based rates are generally higher than the government risk-free rate, discounting with the market-based rate would result in higher costs for FDLP relative to FFELP.

F. Interest Rate Spread for Commercial Paper and Treasury Bills

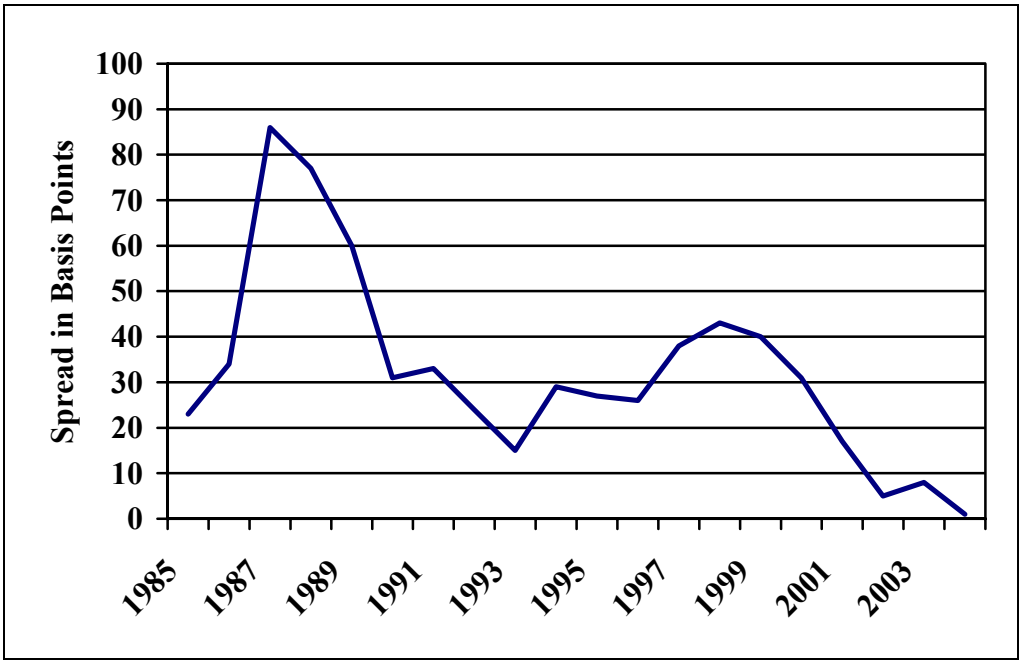
Since 2000, guaranteed lender yields under the FFELP have been based on the yield on commercial paper with a three-month maturity. Prior to 2000, the guaranteed lender rate was based on Treasury bills (T-bills). The amount paid in SAPs depends on the relationship between interest payments to lenders on student loans, which are based on T-bill yields, and the guaranteed yield, which are based on commercial paper yields. The difference, or spread, between these yields determines the size of the SAP.

Between 1985 and 1998, the average spread between three-month commercial paper and three-month T-bills was 43 basis points.[11] However, the spread has generally fallen during the past decade. In 2004, the rates were virtually identical (differing by only one basis point). Figure 5 illustrates the change in the spread since 1985.

Required yields on commercial paper are generally higher than Treasury yields for several reasons. First, issuers of commercial paper have a higher likelihood of default than the government, leading to a credit-risk premium. Second, holders of commercial paper might have trouble finding buyers if they decide to sell, while it is generally thought that the demand for government debt is relatively liquid. As a result, commercial paper must also earn a liquidity premium.[12]

[11] Congressional Budget Office, *A Framework for Projecting Interest Rate Spreads and Volatilities*, January 2000.
[12] The liquidity premium could be offset by the fact that holders generally hold commercial paper until it matures. See CBO (2000) for a discussion of these factors.

Figure 5. Spread between Three-Month Commercial Paper and Treasury Bills
(In basis points)



Source: PricewaterhouseCoopers calculations based on interest rates published by the Federal Reserve (http://www.federalreserve.gov/releases/h15/data.htm).

Spreads also tend to vary over the economic cycle, increasing during economic contractions and decreasing during economic expansions. However, the CBO has argued that certain developments in the last few decades have contributed to lower spreads going forward. Increased stability in financial markets, the elimination of certain financial market regulations, and lower inflation have lowered the magnitude and volatility of spreads.

Given these developments in the financial markets, SAP levels could decline in the future relative to past levels. As a result, the cost of FFELP lending would decrease. To the degree that baseline forecasts by the CBO or the Administration are using spreads between commercial paper and T-bills that do not fully recognize structural changes in the financial markets, they would overestimate the cost of the FFELP.

III. Displacement of Private Sector

Summary: Displacement of the Private Sector

- The true budgetary cost of the FDLP is underestimated because current calculations ignore the loss of taxes on student loan income that would have been generated under the FFELP.
- Using our mid-point assumptions, our estimates indicate that the FFELP generated $651 million of federal tax revenues in FY 2004.
- Some services under the FDLP are performed by private parties and generate tax revenues estimated at $7 million.
- If the entire FFELP loan portfolio were transferred to the FDLP, tax collections are estimated to fall by $631 million, at FY 2004 levels.
- Federal income tax payments should be recognized in any comparison of relative program costs.

Federal score-keeping conventions do not recognize the effects of expenditure programs on federal tax collections. This largely is because tax revenues will not change significantly as a result of how policymakers choose to allocate spending among competing programs. That is, while businesses providing goods and services to the federal government have taxable income and pay taxes[13], different policy choices are unlikely to materially change Treasury tax collections. For example, if the Congress should choose between appropriating funds to pay one contractor a given amount to build Navy ships or another to perform computer systems integration work, either contractor will earn taxable income and pay taxes.

In contrast, a meaningful difference in Treasury tax collections occurs when government policy decisions change the relative size of the federal sector in the nation's economy. The choice to fund the FFELP or FDLP is an example of such a difference. When the Congress created the FDLP, it expanded the federal government's share of the economy and displaced economic activity that was occurring in the private sector. As a result, aggregate taxable income and taxes paid fell relative to what otherwise would have occurred. Similarly, if direct lending should fully replace guaranteed lending and there is no offsetting reduction in federal activity elsewhere, tax revenues also would fall.

Because tax collections attributable to private lenders participating in the federal student loan program activities are a small fraction of total federal revenues, this change in tax collections went unnoticed when the FDLP started. This does not mean, however, that the change is insignificant when considering the budgetary implications of the student

[13] State and local income taxes also will be paid, but are ignored here as these amounts do not directly affect the federal budget.

loan program or when evaluating the difference in the cost of operating the two programs.

To explore these budgetary effects, we provide illustrative calculations of the federal revenue consequences. First, we review the taxes paid by FFELP lenders. Then, because some private sector activity also occurs under the FDLP, we review the taxes paid there. Finally, to focus on the budgetary effects of choosing between the two programs, we show what would happen to tax collections if direct lending were to completely replace FFELP loans. That is, under this scenario, we assume that all outstanding guaranteed loans are held directly by the federal government rather than as they are today.

A. Taxes under FFELP

FFELP participants earn income from a number of sources, including loan interest, special allowance payments, loan sale proceeds, securitization revenues, loan servicing, guaranty agency servicing, software income, loan collection, and investment banking income. Loan sale proceeds and securitization revenue can be viewed as a way to accelerate the income stream on the loan asset. Loan income (stated interest plus special allowance payments net of carrying costs) is the largest income source.

Federal income taxes paid to the IRS are based on a company's reported taxable income. Taxable income generally is equal to revenues less expenses; i.e., its pretax profits. Revenues and expenses are measured somewhat differently for tax purposes than in financial statements. As a result, financial statements provide only an approximate measure of a company's tax base. Financial statements published by publicly-traded companies holding student loans, or generating income from the program, typically are engaged in other activities unrelated to student loans and the amounts reported tend not to separately show their student lending income. For example, many such lenders are full-service financial institutions where student loans are a small fraction of their activities. As a result, published financial statements are of limited value and we need to look elsewhere to find comprehensive data.

A better approach is to use data on the financial returns of all credit intermediaries, which are companies that extend credit using funds received from depositors or raised in the capital markets by issuing debt instruments or borrowing from other financial intermediaries. We develop estimates based on financial relationships using IRS data on the taxable income of all credit intermediaries whether publicly- or privately-held.

This approach should provide a good approximation of the taxes paid by FFELP lenders because competition should force those institutions holding student loans to be about as profitable on a risk-adjusted basis as other lending institutions. If the student loan market should be excessively profitable, especially over a period of time, other lenders would enter the market, thereby forcing profits down. If, on the other hand, student lending consistently generated low profits or losses, some lenders would leave the market, thereby reducing competition and allowing yields to increase. While these tendencies will

be greatest for publicly-held companies, even tax-exempt lenders will be subject to these competitive pressures.

IRS data on the pretax profitability of lenders allow us to compute taxable income as a percentage of all assets held – these assets predominately are the lender's loan portfolio, although total assets also include other financial and nonfinancial resources that contribute to the company's ability to earn income.

The Statistics of Income (SOI) Division of the IRS collects and publishes tax return data by industry. The most recently published data are for 2001 and consistently reported data were first reported in 1998.[14] Table 4 shows taxable income as a percentage of assets for credit intermediaries during this period. The average pretax return on assets was 0.92 percent and ranged from a low of 0.84 percent to a high of 1.07 percent.

Table 4. Taxable Income as a Percentage of Assets for Credit Intermediaries

1998	*1999*	*2000*	*2001*	*Average*
0.92%	0.84%	0.82%	1.07%	0.92%

By applying the average pretax return on assets for all credit intermediaries to the outstanding balance of FFELP loans held by taxable lenders we have the starting point for estimating the federal revenue effects.

Table 5 shows recent data on the total volume of outstanding FFELP loans. These figures are from annual ED financial statements, with the most recent data being for FY 2004. At the end of FY 2004, these data show $245 billion in outstanding FFELP loans; a 15-percent increase over FY 2003.

Table 5. Principal Balances Outstanding of Guaranteed Loans Held by Lenders
(Fiscal years, Dollars in billions)

2000	*2001*	*2002*	*2003*	*2004*
$146	$160	$182	$213	$245

Sources: These balances are from "Note 4. Credit Program Receivables and Liabilities for Loan Guarantees" in financial reports included in "Performance and Accountability Report U.S. Department of Education" for recent years.

[14] While the SOI Division has collected and published these data for many years, the industries published were redefined beginning in 1998 when the North American Industrial Classification System (NAICS) first was used.

Not all FFELP loan holders are subject to tax, and we need to distinguish between tax-exempt and taxable lenders in our calculation of federal revenue effects. Spreadsheet data provided by the ED for the top 100 lenders show a total end-of-FY 2003 loan balance for all lenders equal $203.4 billion. This is about 95 percent of the amount shown in the department's FY 2003 financial statements. We identified 54 of these lenders, with 80 percent of the outstanding loan volume, as taxable.[15]

Thus, if the average relationship of taxable income to assets observed during the 1998 through 2001 period should have been experienced in 2004, we would have expected taxable FFELP lenders to have taxable income of about $1.8 billion (0.92% x 80% x $245 billion).

It generally is appropriate to apply a 35 percent marginal tax rate to taxable income to determine tax liability.[16] This results in annual taxes of $631 million.

Table 6 provides the details of this calculation under a range of assumptions.

Table 6. Calculation of Taxable Income and Tax Liability Resulting from FFELP Activities, FY 2004
(Dollars in millions)

	Low profitability (2000)	*High profitability (2001)*	*Average profitability (1998-2001)*
FY 2004 ending FFELP loan balance	$245,000	$245,000	$245,000
Share earned by taxable participants	80%	80%	80%
Taxable loans	196,000	196,000	196,000
Taxable income as percentage of assets (average)	0.82%	1.07%	0.92%
Taxable income ($ millions)	1,607	2,097	1,803
Top federal marginal tax rate	35%	35%	35%
Federal tax incurred under FFELP	$563	$734	$631

[15] We worked with several knowledgeable industry sources to make these determinations, as well as conducting independent research through web sites of these lenders. Our figures include ownership changes since FY 2003, which increased the taxable share of loans from 77 percent to 80 percent.

[16] Federal corporate marginal tax rates range from 15 percent to 35 percent. A 20-percent corporate alternative minimum tax rate may apply to a broader measure of income if it results in a larger amount of total tax. The 35-percent tax rate is applicable to corporations earning taxable income of $10 million or more. As taxable income exceeds certain thresholds, the benefit provided by the lower marginal rates is recaptured resulting in effective marginal tax rates that can exceed the 35-percent top rate. The great majority of FFELP loans held by taxable entities likely will be subject to the 35-percent rate. Note that this calculation should not be confused with amounts shown in the tax footnotes of a company's financial statements where effective tax rates are measured relative to book earnings rather than to taxable income. A book income-based effective tax rate measure may deviate widely from the federal tax rate actually applied to taxable income for numerous reasons.

State-based student loan secondary market organizations[17], including scholarship funding corporations, play a large and important role in the FFELP and also are the source of federal tax revenues. If the FFELP were to be fully displaced by federal direct lending, a portion of these tax revenues also would disappear. To assess this potential revenue impact, PricewaterhouseCoopers surveyed these organizations. Survey respondents collectively accounted for 57 percent in FY 2003 and 60 percent in FY 2004 of the total balance of outstanding FFELP student loans that are held by the nonprofit institutions and state agencies.

Based on weighted survey responses, these nonprofit institutions and state agencies are estimated to have paid fees to taxable service provides of $373 million in FY 2004. Using IRS data, we estimate that taxable income on these revenues was $25 million, and tax payments were $8 million. An additional $12 million was rebated to the Treasury as arbitrage returns from non-purpose investments.

Using the average profitability assumption from Table 6, Treasury collected a total of $651 million from FFELP-related activities in FY 2004 – $631 million from taxable holders of FFELP loans and $20 million from nonprofit institutions and state agencies that purchased services from taxable companies.

B. Taxes under FDLP

The FDLP indirectly generates some taxable income and tax liability from direct lending activities the ED contracts out to the private sector. These activities include servicing functions, loan consolidation processes, collection activities, processing student loan applications, handling written correspondence, operating a call center, and dispersing money. We do not know the details of the ED's contracts; however, press releases and news articles suggest that this amount currently is at least $280 million annually.[18] The Administration's FY 2006 budget shows that in FY 2004 the combination of contract collection costs and federal administrative costs for the direct lending program were about $470 million[19] and the amount of contractual services probably does not exceed this amount. The costs are estimated to total $553 million in FY 2006.

Annual ED financial statements show that at the end of FY 2004, the principal balances outstanding of direct loans was $89.2 billion, a six-percent increase over FY 2003. The principal balances for FY 2000 through 2004 are provided in Table 7.

[17] According to the Education Finance Councils web site, these organizations raise money by selling bonds to investors, and then use that money to make student loans and to acquire them from banks, savings and loans and credit unions. This allows these institutions to make more loans. In acquiring loans from the original lenders, secondary markets assume the long term servicing and collection responsibilities and share in the risks associated with defaults. (See www.efc.org)

[18] See "Taxpayers Stand To Save $1 Billion Under New Contract," released by the Department of Education on November 20, 2003, and "Pearson to Integrate Student Aid Programs," Washington Post, February 14, 2005.

[19] See "Fiscal Year 2006 Budget of the U.S. Government, Appendix," p. 371. This likely will be the highest possible estimate because it includes all direct lending administrative costs, including ED salaries and fringe benefits.

Table 7. Principal Balances Outstanding of Direct Loans Held by the Department of Education
(Fiscal years, Dollars in billions)

2000	*2001*	*2002*	*2003*	*2004*
$58.5	$70.5	$80.1	$84.5	$89.2

Sources: These balances are from "Note 4. Credit Program Receivables and Liabilities for Loan Guarantees" in financial reports included in "Performance and Accountability Report U.S. Department of Education" for recent years.

Table 8 provides estimates of the federal income tax liability generated by the payments to FDLP contractors. Because of our uncertainty as to the exact amount the ED spent on private contractors, we estimate a range of total revenues between the low amount of $280 million as reported in press accounts, and the high amount of $470 million from the budget. We average these amounts to provide a mid-point estimate. The profit margin on federal contracts tends to be relatively narrow and we assume that it equals five percent of revenues. We also reviewed IRS data on the profitability of information services and data processing services corporations. During the 1998 through 2001 period, taxable income averaged 4.9 percent of total revenues. As discussed above in our computations for FFELP lenders, we assumed a 35-percent marginal tax rate. This resulted in taxes ranging between $5 and $8 million, with the average being $7 million.

Table 8. Estimated Taxable Income and Tax Liability Resulting from FDLP Activities, FY 2004
(Dollars in millions)

	Lower contracting cost estimate	*Higher contracting cost estimate*	*Average of cost range for contracting costs*
FY 2004 ending loan balance	$89,245	$89,245	$89,245
Administrative costs contracted out to private sector	280	470	375
Contracting costs as a percentage of loans	0.31%	0.53%	0.42%
Estimated taxable income as a percentage of revenues	5%	5%	5%
Taxable income	14	24	19
Top federal marginal tax rate	35%	35%	35%
Federal tax incurred under direct lending	5	8	7
Note: Taxable income as percentage of loans	0.016%	0.026%	0.021%

C. Difference in Tax Collections between the FFELP and FDLP

If the FDLP were to fully replace FFELP with the total FFELP loan volume held by the federal government, total taxable income and Treasury tax collections would fall. We estimate this effect by substituting the FDLP-related taxable income factors provided in Table 8 for the FFELP taxable income factors in Table 6. Our calculations provided in Table 9 show a difference in FY 2004-level tax collections of $631 million.

The implication of these calculations is that the budgetary costs of the FDLP are higher than currently estimated by the CBO or the Administration due to foregone income tax collections, and the estimated budgetary savings that may result from shifting FFELP loan volume to the FDLP is overestimated by the amount of foregone federal tax collections. These federal income tax payments should be recognized in any comparison of relative program costs.

Table 9. Estimate of Taxable Income and Tax Liability Resulting from FFLEP Activities if Administered under FDLP, FY 2004
(Dollars in millions)

	Current law FFELP	*FFELP activities if administered by FDLP*	*Change in taxes due to FDLP administration*
FY 2004 ending FFELP loan balance	$245,000	$245,000	
Share earned by taxable participants	80%	100%	
Taxable loans	196,000	245,000	
Taxable income as percentage of assets	0.92%	0.021%	
Taxable income ($ millions)	1,803	51	
Top federal marginal tax rate	35%	35%	
Federal tax incurred under FFELP	631	18	-613
Taxes and rebate attributable to nonprofit institutions and state agencies [a]	20	2	-18
Total	$651	$20	-$631

[a] Some taxes will continue to be paid on the loan volume currently held by nonprofit institutions and state agencies. These are attributable to loan servicing and collection activities that would be performed by private sector contractors even if administered under the FDLP. Up to $2 million of additional taxes could be paid if the ED must incur and contract out additional costs for software. This will depend on whether the ED incurs per transaction software licensing costs, where any increase in loan volume would lead to an increase in fees.

IV. The Budgetary Treatment of Administrative Costs

Summary: Administrative Costs

- The CRA requires that administrative costs be excluded from the subsidy calculations for the FDLP and FFELP; however, while all administrative costs are excluded from the FDLP cost estimates, they are mostly included in FFELP estimates because most of the costs are incurred by private lenders. This inconsistent treatment makes the FDLP program appear relatively less costly than it is.
- Origination fees collected under the FDLP program are included in the subsidy estimates even though origination costs are not. Under the FFELP, origination costs are implicitly included in the lender yield, so fees and the associated costs are included in the subsidy estimates.
- The current allocation of ED administrative costs shows the administrative costs associated with the FDLP are almost five times higher relative to outstanding loans than those for the FFELP.
- Federal administrative costs for the FFELP relative to outstanding loans have been cut in half since 1991.

As required by the CRA, program costs of the FFELP and FDLP are not included in estimated subsidy costs and, as a result, the lower relative costs to the government of the FFELP go unrecognized. The CRA defines program costs as follows:

- The cost of a direct loan is defined as "the net present value … of cash flows [for] loan disbursements, repayments of principal, and payments of interest and other payments by or to the government over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties and other recoveries."

- The cost of a loan guarantee is defined as "the net present value … [of] estimated payments by the government to cover defaults and delinquencies, interest subsidies, or other payments, and the estimated payments to the government including origination and other fees, penalties and recoveries."

These costs are recorded on the program's budget (in its "program account") in the year the loan or guarantee is issued, and the estimates are updated annually to reflect changes in financial market conditions, the performance of the individual credit programs to date (such as repayment experience), and revisions to other technical assumptions. In both cases, direct administrative costs associated with the programs are not included. Because most FFELP administrative costs are borne by the lender and must be covered by the interest rate spread, they are implicitly included in FFELP subsidy estimates. As a result, these scorekeeping rules introduce a bias that makes the FDLP appear less expensive.

A. Description of Administrative Costs

The administrative costs incurred under the student loan program come from a wide variety of activities. Students, private lenders, guaranty agencies, the federal government, and other private players each pay a portion of the administrative costs associated with the operation of the program. These costs include the following:

- Pre-loan activities. Before a loan can be disbursed, students must learn about the program and determine the appropriate type and amount of student loan. Private lenders, guaranty agencies, and educational institutions help prospective and current students by providing information on the student loan program, counseling students on borrowing, and determining eligibility under the program.

- Originating and disbursing the loan. Once a student submits a valid application for a loan, the lender must first originate the loan. Origination of the loan entails raising funds to lend out and create a loan vehicle that meets the requirements of the student loan program. Once the loan has been originated, the actual funds can be disbursed to the student directly or the educational institution. Records of the loan must be created and maintained.

- Servicing the loan. Once the loan has been disbursed, records of the loan must be maintained and updated. Information on the balance and repayment options must be provided to the student, and lenders must be available to answer questions from borrowers.

- Default aversion. Guaranty agencies and lenders intensify their activities once a loan becomes delinquent, with the objective of averting a default.

- Defaults. Default on a student loan imposes costs in addition to the amount of the balance owed. Guaranty agencies and collection agencies are involved with encouraging the resumption of payments. Lenders must be reimbursed for guaranteed amounts.

- Consolidation activities. Borrowers can consolidate multiple loans into a single loan. Some of the administrative costs associated with loan consolidation are similar to those already described, but some aspects differ. Loan consolidators must work with the original lenders to close out the old loans and establish the new interest rate on the consolidated loan.

- Regulating, auditing, and enforcing the program. The federal government establishes the rules for the student loan program and is responsible for ensuring that all participants abide by those rules. In the FFELP, much of the program administration and enforcement is performed by guaranty agencies. In addition, legislative changes must be incorporated periodically, forms must be updated, and market developments must be monitored.

In the FDLP, all these activities are funded by the ED. In the FFELP, some of these administrative costs are explicitly covered by fees paid to guaranty agencies, while others are paid by lenders from their return on lending.

B. Budgetary Treatment of Administrative Costs under CRA

While the CRA greatly improved the comparability of cost estimates for federal loans and guarantees, it effectively biased cost comparisons in favor of direct lending and against guaranteed lending by omitting the ED's administrative costs from subsidy calculations.

The administrative costs excluded from the subsidy estimates are higher for direct loans than for guaranteed loans. All direct loan administrative costs are excluded from the FDLP program cost calculation, while only a much smaller set of costs are excluded for FFELP.[20] Specifically, only the administrative costs incurred by the ED are excluded from the FFELP subsidy estimates.

The CRA effectively includes some guaranteed loan administrative costs (such as loan origination and servicing) in the net present value calculation for FFELP because they are partly or wholly included in the interest rate subsidy. That is, in the normal course of business (for non-subsidized loans) private-sector lenders set competitive market interest rates on their loans high enough to cover their administration costs plus their cost of funds, with adjustments for risk. Because the interest subsidy and SAP on guaranteed student loans are intended to make up the difference between the rate paid by the borrower and the competitive market rate on such loans, these subsidies implicitly include compensation for private-lender administrative costs.

The costs excluded from the FDLP subsidy cost estimate include expenses for activities related to credit extension, loan origination, and loan servicing; payments to contractors, other government entities, and program participants; management of contractors; collection of delinquent loans; and write-off and close-out of loans. While all FDLP loan origination costs are excluded from the calculation under the CRA, the origination fees paid by borrowers are included in FDLP program revenues, creating a clear bias. In the case of guaranteed loans, these administrative costs are borne by private-sector lenders and guaranty agencies, are covered by the payments they receive on the loans (including interest subsidies from the federal government), and thus are included in the estimated net present value of guaranteed loan subsidies.

Absent an amendment to the CRA, or specific direction from the Congress, the CBO does not have the authority to depart from CRA procedures.[21] Similarly, the Administration may not depart from the letter of the CRA in preparing its own subsidy cost estimates for budget purposes. As a result, CRA rules continue to impart a downward bias to student

[20] Instead of including FDLP administrative costs in the calculation of FDLP program costs, these costs show up elsewhere in the ED's budget and are funded separately.

[21] The FY 1996 budget resolution directed the CBO to include direct loan administrative costs in its subsidy cost estimates, notwithstanding the provisions of CRA. However, the budget resolution does not have the force of law, did not govern the Administration's cost estimates, and applied only to the FY 1997 CBO budget estimates.

loan subsidy costs, and distort comparisons of direct and guaranteed loan costs to the detriment of guaranteed lending.

C. Administrative Costs Incurred by the Federal Government

The federal government pays a portion of the administrative costs associated with both the FDLP and FFELP. As illustrated in Table 10 below, estimates presented in the FY 2006 budget shows that the ED incurs administrative costs for the FFELP that are significantly lower than those incurred by the FDLP ($232 million relative to $389 million in FY 2004). The difference is even more striking when calculated relative to outstanding loans. The ED pays $43.53 in administrative costs for each $10,000 in loans under the FDLP but only $9.44 under the FFELP. Thus, when adjusted for volume, these administrative costs are almost five times higher in FDLP.

As some expenditures are difficult to divide between the two programs, comparing the federal administrative costs before and after the FDLP came into being provides another perspective on the costs of each program. Assuming the government role in the FFELP has changed little over time, any change in federal administrative costs relative to total outstanding loans should be attributable to the FDLP.

Table 10. FFELP and FDLP Administrative Costs, FY 2004-2006

	2004	*2005*	*2006*
	Administrative Cost in Millions		
FFELP	$232	$229	$238
FDLP	$389	$396	$407
	Administrative Cost Per $10,000 in Loans		
FFELP	$9.44	$8.24	$7.67
FDLP	$43.53	$41.41	$39.04
	Outstanding Loans in Millions		
FFELP	$245,254	$278,379	$310,393
FDLP	$89,245	$95,700	$104,340

Source: FY 2006 Budget and PricewaterhouseCoopers calculations.

In 1991, total administrative costs for the FFELP were approximately $120 million (the FDLP began in 1994). By 2004, administrative costs for both programs grew to $621 million (as presented in Table 10 above). Federal costs for the FFELP has fallen from about 0.2 percent of outstanding loans in 1991 to 0.1 percent in 2004. In comparison, the FDLP represents about 0.5 percent of outstanding FDLP loans.

About the Authors

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